Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:CTR:HAR:TL-N-6343-99
GAThorpe

date: December 6, 1999

to: Chief, Examination Division, Connecticut-Rhode Island District
ATTN: [redacted]

from: District Counsel, Connecticut-Rhode Island District, CC:NER:CTR:HAR

subject: [redacted]

On November 24, 1999, we sent a memorandum to you, under our post 10-day review procedures, in which we provided advice concerning the Service's obligation to provide information to the [redacted] taxing authorities under the tax treaty with that country. Based on further guidance received from our National Office, we wish to modify that advice as follows:

On page five of our November 24, 1999, memorandum, we indicate that it is the Service's policy to make a "spontaneous exchange" of information in all cases where the convention permits disclosure. However, there are two exceptions to this general rule. First, the Service generally will not make a "spontaneous exchange" of information unless the treaty partner would reciprocate in a similar situation. (The Assistant Commissioner may waive this reciprocity requirement if such action is deemed advisable.) Second, the Service will not "spontaneously exchange" information if such action would violate some public policy or harm tax administration. As indicated, the Assistant Commissioner (International) makes the final decision concerning the application of these exceptions

The advice we gave to you in our November 24, 1999 memorandum, as modified herein, is now final. Should you have any additional questions, please contact Carm Santaniello at (860) 290-4075. Since this appears to end our involvement in this matter, we have closed our file for this advisory opinion.

(Signed) Gerald A. Thorpe

GERALD A. THORPE
District Counsel

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:CTR:HAR:TL-N-6343-99
CJSantaniello

date: NOV 24 1999

to: Chief, Examination Division, Connecticut-Rhode Island District
Attn: [redacted]

from: District Counsel, Connecticut-Rhode Island

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subject: **Large Case Advisory - [redacted]**

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We are partially responding to your memorandum dated June 9, 1999, in which you requested advice regarding the following three questions:

> (1) If a [redacted] license agreement between the taxpayer and its [redacted] subsidiary, under which the subsidiary received the right to use the taxpayer's technology within a certain territory in return for the payment of a [redacted] percent royalty, whether an adjustment to the taxpayer's taxable income should be made under I.R.C. § 482[1] or by simply requiring the parties to comply with the terms of the license agreement?

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[1] All section references are to the Internal Revenue Code in effect during the taxable years in question.

(2) Whether section 6662(e) applies where an adjustment to taxable income is based on the Service's requiring the parties to comply with the terms of the license agreement, rather than a reallocation of income based on a change to "arm's length pricing?"

(3) Is the Service obligated under the tax treaty with [redacted] to report incidents of unreported income to the [redacted] taxing authorities and, if so, what procedures must be followed?

On October 25, 1999, we referred issues (1) and (2) to [redacted] in the Northeast Regional Office. [redacted] Because [redacted] will respond to your request on these two issues, please direct all inquiries regarding them directly to him.

Regarding issue (3), disclosures of returns and return information to foreign taxing authorities are permitted under section 6103(k)(4) where an income tax convention provides for exchange of information. Because the tax treaty between [redacted] and the United States provides for the exchange of information, the Service may disclose the return information in question to [redacted]. Disclosure of such information under the treaty, however, is reserved exclusively to the Assistant Commissioner, International.

This memorandum is being simultaneously submitted to the National Office for review under our post 10-day review procedure. Consequently, you should not take any action based on the advice contained herein during the review period.

Facts

This is a [redacted] case involving the taxpayer's taxable years [redacted] and [redacted]. The taxpayer's taxable years [redacted] through [redacted] are [redacted]. An issue common to each year is whether the taxpayer should have received royalties from several of its controlled foreign corporations for the use of its technology, patents, trade names, trademarks, brand names, know-how, and other [redacted] developed intangibles. The present issue is limited to the amount of royalty income attributable to one of its CFCs, [redacted].

On [redacted], the taxpayer (formerly [redacted]) entered into a license agreement with its wholly-owned subsidiary, [redacted] (previously [redacted]). Under this agreement, [redacted] received the exclusive right to make and sell in the "territory" all "licensed products," access to the taxpayer's technology, a promise of continued technical assistance from the taxpayer, the right to use the taxpayer's name and brands, a a general right to sublicense those rights to third parties. The term of the agreement was [redacted] years ([redacted] years with an automatic [redacted] year renewal). As consideration, [redacted] agreed to pay the taxpayer a royalty equal to [redacted] percent of the net sales price of all licensed products sold by [redacted] during the life of the agreement.

Based on the examinations of prior cycles, the audit team assumed that the agreement had lapsed pursuant to its stated term. However, after the audits were concluded and while the case was pending in Appeals, the audit team learned that the taxpayer maintained that the agreement remained in force and effect. By letter dated [redacted] to the Appeals Officer considering the [redacted] and [redacted] years, the taxpayer's representative stated as follows:

> [redacted] contends that any royalties due to it were paid pursuant to a License Agreement dated [redacted] (the "License Agreement"). Under the License Agreement, [redacted]'s predecessor, [redacted] ("[redacted]") licensed to [redacted] ("[redacted]") the right to sell those of its products not already transferred to [redacted] under a [redacted] Agreement of Sale, for a royalty of [redacted] ([redacted]) percent of the selling price. [redacted] sublicensed these products to the other [redacted] subsidiaries for a royalty of [redacted] ([redacted]) percent. The base for the royalties paid was the revenue earned from those products that were sold by [redacted] to third parties and affiliates and that were produced using [redacted] developed and owned technology.

Alerted by this statement, the audit team attempted to determine whether any documents existed to verify the representative's claim that the license agreement remained in effect beyond its stated ten-year term. The team eventually located a letter agreement dated [redacted]. This letter agreement, between [redacted] and [redacted], provides as follows:

> This will confirm the fact that the license agreement dated [redacted], having been renewed for a successive [redacted] ([redacted]) years ending [redacted], [redacted], [redacted] and [redacted], is fully in force and effect and will continue to be automatically renewed for successive periods of [redacted] ([redacted]) years unless notice of intention to terminate the agreement is given by one of the parties to the other party at least [redacted] ([redacted]) months prior to the expiration of any [redacted]([redacted]) year term.

To date, no evidence has been produced to establish that the license agreement has been terminated pursuant to the letter agreement.

During the current cycle, the audit team attempted to determine through the issuance of Information Document Requests (IDRs) the exact status of the original license agreement. These IDRs were issued on [redacted], [redacted], and [redacted]. To date, the taxpayer has not responded to any of the IDRs. However, in response to IDR No. [redacted], issued on [redacted], in lieu of any inter-company pricing study under section 6662(e), the taxpayer stated:

> Unless stated to the contrary, we are using the [redacted]% royalty rate as proposed as an arm's length rate by the IRS during the prior audit cycles. We will continue using this rate until [redacted].

During the years [redacted] and [redacted], the taxpayer did not comply with the terms of the license agreement. During those years, payments received by the taxpayer from [redacted] are only a fraction of the [redacted] percent called for by the license agreement. According to the audit team, significant adjustments to the taxpayer's [redacted] and [redacted] taxable income will result if the taxpayer is required to comply with the express terms of the agreement.

Relevant Law & Analysis

Disclosure of tax returns or return information to foreign tax authorities is normally prohibited by section 6103, except in the case where an income tax convention provides for the exchange of information. In that instance, section 6103(k)(4) permits disclosure to the competent authority of the treaty partner, but

only to the extent provided in, and subject to the terms and conditions of, the convention.

[redacted] and the United States signed an income tax convention on [redacted]. [redacted]. [redacted] of the convention, entitled "Exchange of Information," provides:

> The competent authorities of the [parties] shall exchange such information as is pertinent to carrying out the provisions of this Convention or preventing fraud or fiscal evasion in relation to the taxes which are the subject of this Convention.

A Supplemental Protocol was signed on [redacted], amending the convention. The amendments did not affect [redacted].

Because tax convention between [redacted] and the United States provides for the exchange of information, the information in question may be disclosed to the [redacted] competent taxing authorities under section 6103(k)(4), with or without a specific request therefor. An exchange made without a specific request therefor is referred to as a "spontaneous exchange of information," defined as the "furnishing to a treaty partner, without a specific request, of information which is discovered during a tax examination or investigation and which suggests or establishes noncompliance with the tax laws of a treaty partner which are subject to the convention." See U.S. Delegates' Briefing Paper, cited in Venuti, Gordon & Crocker, 940 T.M., Income Tax Treaties - Administrative and Competent Authority Aspects, worksheet 12. See also 4.3.1.1, International Procedures Handbook, ¶ 9.4(1), cited in Venuti at worksheet 15. The current policy of the United States is to make spontaneous exchanges of information in all cases where the convention permits disclosure. U.S. Delegates' Briefing Paper.

The procedures for making spontaneous exchanges of information are set forth in 4.3.1.1, International Procedures Handbook, at ¶ 9.4(1) through (3), worksheet 15. Under these procedures, examiners proposing to furnish information to a treaty partner should send the information to the District Director. 4.3.1.1, International Procedures Handbook at ¶ 9.4(2). The information is then forwarded through the Regional Compliance Officer to the Assistant Commissioner (International). Id. at 9.4(3). Disclosures to competent authorities are made exclusively by the Assistant Commissioner (International). Id. at ¶ 9.4(3); section 6301(k)(4).

Please call Carmino Santaniello at (860) 290-4075 if you have any questions or require further assistance.

GERALD A. THORPE
District Counsel

By: (Signed) Carmino J. Santaniello
CARMINO J. SANTANIELLO
Attorney